

Franchise Tax Board**ANALYSIS OF ORIGINAL BILL**

Author: Calderon Analyst: Gail Hall Bill Number: ABX3 32
Related Bills: See Legislative History Telephone: 845-6111 Introduced Date: September 5, 2008
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Repeal Water's-edge Election/Repeal Provisions Allowing Corporations to Make Election

SUMMARY

This bill would repeal specific provisions of the franchise tax law relating to water's-edge taxpayers.

PURPOSE OF THE BILL

The intent of the bill appears to address the fiscal emergency declared by the Governor by proclamation issued January 10, 2008, by repealing provisions that would result in an increase in state revenues.

EFFECTIVE/OPERATIVE DATE

As a tax levy this bill would be effective immediately and if enacted in 2008, apply to taxable years beginning on or after January 1, 2008.

POSITION

Pending.

ANALYSIS**FEDERAL LAW**

To understand this bill, it is necessary to understand the general federal rules for taxing a U.S. corporation versus a foreign corporation. In general, a U.S. corporation is taxed on all its income, regardless of source, and is allowed a tax credit for any taxes paid to a foreign country on its foreign-source income. Foreign corporations are generally excluded from filing a federal tax return, except a foreign corporation is taxed on all of its income from U.S. sources. Examples of U.S.-source income are:

1. income earned by a foreign corporation's sales office located in the U.S.,
2. royalties paid from a U.S. corporation to a foreign corporation, and
3. interest paid from a U.S. corporation to a foreign corporation.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Brian Putler for
Selvi Stanislaus

02/17/09

STATE LAW

If a taxpayer does not make a water's-edge election, it must use the worldwide combined reporting method to file its state taxes, and its unitary business income from both domestic and foreign operations is considered in the calculation of state tax. A share of that business income is "apportioned" to California. The amount to be apportioned to California is determined by a formula. The formula measures relative levels of business activity in the state using the amounts of the taxpayer's property, payroll, and sales in California. These measures of activities are commonly called "factors." The factors from both domestic and foreign activities are included in the calculation of the apportionment formula.

As an alternative to the worldwide combined reporting method, California law allows corporations to elect to determine their business income on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business income. There are exceptions to this general rule as certain affiliated foreign corporations, if unitary with an entity that is a member of the water's-edge group, are includable in the water's-edge combined report (group tax filing).

A water's-edge election must be for an initial term of 84 months and remains in effect thereafter, year to year, until terminated by the taxpayer. If a taxpayer terminates its water's-edge election, it is required to file on a worldwide basis for at least 84 months before making another water's-edge election.

Generally, California conforms to the federal rules for U.S.-source income discussed in the "current federal law" section above.

THIS BILL

This bill would repeal the water's-edge provisions effective January 1, 2008.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

TECHNICAL CONSIDERATIONS

Subsequent legislation may be required to eliminate references to the water's-edge provisions in other Revenue and Taxation Code Sections. This could be accomplished in Legislative Counsel's annual technical bill.

LEGISLATIVE HISTORY

SB 1876 (Alpert, 2003/2004) was similar to this bill and would have repealed the water's-edge provisions. For taxable years beginning on or after January 1, 2004, taxpayers would no longer be allowed to elect to determine their income on a water's-edge basis. Existing elections would be rescinded for taxable years beginning on or after January 1, 2004. SB 1876 was held in the Senate Appropriation Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Research was performed to determine if these states had water's-edge provisions similar to California.

Illinois lacks water's-edge provisions similar to California but exclude a member from a combined group if that member's business activity outside the U.S. is 80% or more of its total business activity.

Massachusetts's uses a water's-edge method similar to California for reporting members of a combined group's taxable income. Members of a combined group may elect to use the worldwide method of reporting taxable income.

Michigan lacks water'-edge provisions similar to California but has adopted water's-edge rules for excluding a foreign operating entity from the calculation of its Michigan Business Tax.

Minnesota lacks water's-edge provisions similar to California but excludes subsidiaries that are incorporated outside of the U.S. from the unitary group's business income. The unitary group does include 100% of any dividend income received from a foreign subsidiary but the dividend received by the group is reduced by an 80% deduction.

New York lacks water'-edge provisions similar to California but taxes foreign corporations that are engaged in doing business in New York City (NYC), employing capital in NYC in a corporate form or capacity, owning or leasing property in NYC in a corporate capacity or form, or maintaining an office in NYC.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

The revenue impact of this proposal is estimated to be as shown in the following table:

Estimated Revenue Impact of ABX3 32 Effective for tax years BOA 1/1/2008 Enacted after 6/1/2008 (\$ in Millions)			
2007-08	2008-09	2009-10	2010-11
796	725	763	836

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The above revenue impact was estimated from a comparison of the change in tax data of corporations before and after filing water's-edge. The estimated impact was then extrapolated into future years to account for the growth in the number of corporations electing water's-edge, and changes in corporate profit.

ARGUMENTS/POLICY CONCERNS

- The water's-edge method of taxation was enacted because of controversy over California's application of the unitary business concept to multinational corporations. Repealing the water's-edge election could reopen this international controversy and could result in federal legislation.
- This bill would rescind existing water's-edge elections. Industry would likely argue that they should be allowed to complete the terms of their current water's-edge elections (finish the seven-year election period).

LEGISLATIVE STAFF CONTACT

Legislative Analyst
Gail Hall
(916) 845-6111
gail.hall@ftb.ca.gov

Revenue Manager
Rebecca Schlusser
(916) 845-5986
rebecca.schlusser@ftb.ca.gov

Legislative Director
Brian Putler
(916) 845-6333
brian.putler@ftb.ca.gov